

United States
COURT OF APPEALS
for the Ninth Circuit

OTTO W. HEIDER,

Appellant,

vs.

SAMUEL A. McALLISTER, Trustee in Bankruptcy
of the Estate of Rand Truck Lines, Inc.,

Appellee.

BRIEF OF APPELLEE

*Appeal from the United States District Court for the
District of Oregon.*

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*Appeal from the United States District Court for the
District of Oregon.*

SUPPLEMENTAL STATEMENT OF THE CASE

Appellee believes that a more complete and accurate statement of the case, than contained in the appellant's brief, would be of material assistance to the court in determining the question of jurisdiction, the only question urged by the appellant.

An order to show cause was issued by the referee before whom the matter was pending, the Honorable Estes Snedecor, requiring the appellant to appear on July 6, 1949, and show cause why certain property of the bankrupt in the possession of the trustee claimed to be subject to a mortgage in appellant's favor, should

not be sold free from liens with the proceeds impressed with such liens as the court should determine to be valid (Referee's Certificate R. 41).

In response to this order the appellant filed his proof of secured claim, with the mortgage and notes attached thereto in the bankruptcy court June 30, 1949 (R. 5-19).

A hearing was had on July 6, 1949, as the result of which an order was entered by the referee, with the consent of the appellant (R. 105-106), authorizing the sale of the tangible assets free from the claim of any mortgage held by appellant and "providing that the proceeds of the sale be impressed with the lien of such mortgage or claimed mortgage, the court expressly reserving the right and power to determine the validity or amount due upon such mortgage" (Referee's Certificate R. 41).

Thereafter such assets were sold and the proceeds collected. The order authorizing the sale provided that the proceeds of the sale should be impressed with the liens found upon the personal property so sold "with this court reserving the power to determine the validity and amount of all such liens" (Referee's Certificate R. 41).

On the same day as the entry of this order, an order was entered authorizing a suit by the trustee, in the state courts, against officers and directors of the bankrupt corporation and Otto W. Heider, appellant herein, for the recovery of certain corporate funds used by such officers and directors and delivered to the appellant in

an attempt to pay personal obligations owing by them to him (R. 41-42).

Such suit was commenced in the Circuit Court of the State of Oregon for the County of Multnomah.

In response to the trustee's Fourth Amended Complaint in this suit the appellant included in his answer a counterclaim seeking to foreclose the identical note and mortgage that is the basis of his claim filed in the bankruptcy court (Ex. 33).

As to the trustee, after alleging his appointment, the appellant alleged:

"The plaintiff herein (trustee) holds funds in his possession belonging to the defendant, Otto W. Heider, which have not been, and should be, applied in payment and in satisfaction of the balance due upon said note and mortgage above described; and the property therein set forth is held as security therefor, and said mortgage is a first and prior and unsatisfied lien against said personal and real property and is unsatisfied."

The prayer asked for a decree determining said mortgage to be a valid and subsisting and prior obligation against the property involved and that the funds in the hands of the plaintiff (trustee) should first be applied in satisfaction thereof and that appellant be allowed attorney fees.

The trustee, in his reply to this counterclaim, pleaded in abatement thereto, that at the time of adjudication in bankruptcy of bankrupt, certain property was owned by it and in its possession; that the trustee took possession of the same and sold it free from liens pursuant to orders of the bankruptcy court; that the trustee had

certain funds in his possession received from the sale of such property as well as other funds; that the appellant had filed a claim in the bankruptcy proceedings for the claimed balance due upon the note and mortgage which claim had not been acted upon but was still pending; that by reason of such bankruptcy proceedings, the exclusive jurisdiction of the United States District Court for the District of Oregon over the funds in the trustee's possession, and the claim of appellant filed in such proceedings, the counterclaim of appellant should be abated and appellant relegated to his rights in the bankruptcy proceedings (Ex. 33), and in his reply to the merits of the alleged counterclaim, the trustee pleaded the defense of usury.

Under Oregon procedure, this reply to the merits of the counterclaim was joined with the plea in abatement. The action in the State court is still pending and the plea in abatement has not been determined.

Thereafter, objections were filed to appellant's claim in the bankruptcy proceedings.

A motion to dismiss such objections was made "on the ground that the bankruptcy court is without jurisdiction to entertain these objections because the same matter has been submitted to the Circuit Court of the State of Oregon for the County of Multnomah. . . ." (R. 29).

This motion was denied. The referee said (R. 155):

"The only matter before this court is the validity of his claim and the mortgage securing his alleged claim. I don't think this court can relinquish paramount jurisdiction to determine that matter."

As stated in the referee's certificate (R. 42) he ruled that

"The action in the state court is for the recovery of corporate funds and only indirectly involves the question of the validity of the Heider mortgage."

Upon the hearing, appellant's claim was denied. On appeal to the District Court for Oregon, the referee's decision was affirmed. The appellant then brought his appeal to this court.

ON OTHER ISSUES

We have confined the statement of the case to the jurisdictional question since the appellant is not urging the other specifications of error.

STATUTES INVOLVED

The provisions of the Bankruptcy Act involved in this case are (Title 11, Ch. 2, Sec. 11 USCA):

"Creation of courts of bankruptcy and their jurisdiction:

"(a) The Courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this title . . . to—

* * *

"(2) Allow claims, disallow claims, reconsider allowed or disallowed claims and allow or disallow them against bankrupt estates;

* * *

“(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided, . . . ”

ANSWER TO SPECIFICATION OF ERROR

The lower court was correct in denying appellant's motion to dismiss on jurisdictional grounds.

SUMMARY OF ARGUMENT

The suit was properly brought in the state courts but that suit was and is separate and distinct from the claim filed by the appellant in the bankruptcy court and the objections filed thereto.

The fact that the trustee will be bound by the decision in the state courts, as to the cause of action being pressed by him in that court, does not have any effect upon the litigation in the bankruptcy court with reference to the claim filed by the appellant.

Authority to commence the state court litigation was not an abdication by the bankruptcy court of its powers and jurisdiction to administer the estate of the bankrupt, and to pass on claims filed in said estate, and the validity of liens upon funds in its possession. Consent of bankruptcy court to action against trustee in state courts can be revoked prior to adjudication.

Allowance and disallowance of claims filed therein, is within the exclusive jurisdiction of the bankruptcy court.

Determination of the validity of liens claimed to exist against property in its possession is within the exclusive jurisdiction of the bankruptcy court.

In this case, the bankruptcy court, by its orders, expressly reserved to itself, the power and right to determine the validity of appellant's lien.

Appellant submitted to the jurisdiction of the bankruptcy court, filed his claim therein, and consented to the sale of the personal property free from the lien of his alleged mortgage. Appellant is bound by the orders of the bankruptcy court reserving the right and power to determine the validity of liens claimed against the property in its possession and cannot oust that jurisdiction by asserting the same claim in the state court proceedings.

ARGUMENT

In the opening portion of his argument, appellant makes numerous statements not in accord with the facts and record. The referee never authorized nor consented to the litigation, in the state courts, of the merits of appellant's claim; the trustee objected to its assertion in that court on the ground that the bankruptcy court had exclusive jurisdiction thereof (Ex. 33) and the referee, in denying the motion to dismiss the objections to appellant's proof of claim did so on the ground that the bankruptcy court had exclusive jurisdiction to pass upon the same (R. 155). The court will recognize other discrepancies.

Luikart v. Farmers Lumber Co., 38 F.2d 588, cited to the effect that a federal court has no power to supervise a state court, is not in point. In that case, an action was commenced in the federal courts to annul and vacate a judgment of the courts of the State of Wyoming. The court refused the relief asked.

Answer to Contention That Suit Is Properly Brought in the State Court

The trustee has no quarrel with the proposition that the suit was properly brought in the state courts and that as to the cause of action set out in his complaint filed therein the state court's adjudication will be final. But that is not the question involved here.

The question for decision is whether the appellant can nullify the proceedings in the bankruptcy court, oust the bankruptcy court of its jurisdiction to pass upon claims filed with it, and of its jurisdiction to determine the validity of liens claimed to exist upon property in its possession, by asserting a counterclaim in the state court litigation.

The authorities cited by appellant recognize the paramount jurisdiction of the bankruptcy court under such circumstances.

The extraordinary relief of mandamus was denied the trustees in *Ex Parte Baldwin*, 291 U.S. 610 (App. Br. 8), but it was pointed out that the trustees could have applied to the bankruptcy court for injunctive relief to restrain action in the state courts. The court said (p. 616):

“The inherent power of the bankruptcy court to protect its jurisdiction, over property of which it has taken possession, from interference by suit thereafter begun in a state court has not been abridged. . . .”

Herman v. Cullerton, 13 F.2d 754, 755, quoted by appellant (App. Br. 8) involved a fund paid into the state court, where the trustee appeared and defended. It was held the trustee was bound by the state court judgment, but the court indicated that the result would have been otherwise had the fund been in the possession of the bankruptcy court.

Thompson v. Magnolia Co., 309 U.S. 478 (App. Br. 8), involved oil rights upon railroad right of ways. The court said at p. 483:

“A court of bankruptcy has an *exclusive and non-delegable* control over the administration of an estate in its possession. But the proper exercise of that control may, where the interests of the estate and the parties will best be served, lead the bankruptcy court to consent to submission to state courts of particular controversies involving unsettled questions of state property law and arising in the course of bankruptcy administration.”

In the instant case, not only was there no consent by the bankruptcy court to litigation in the state courts of the merits of the appellant's claim to a note and mortgage upon the assets of the bankrupt corporation, but the approval or disapproval of claims is within the “exclusive and non-delegable” jurisdiction of the bankruptcy court.

Answer to Contention That the Issues Are Identical

The issues in the complaint filed by the trustee in the state court were, basically, the transfer of property of the bankrupt in fraud of creditors and conversion thereof by the officers and directors of the bankrupt, and the appellant, Otto W. Heider.

When the alleged counterclaim was asserted, the trustee coupled his plea in abatement raising the question of jurisdiction with an answer to the merits of the alleged counterclaim.

Such procedure is proper under Oregon practice and does not waive the jurisdictional question.

Credit Service Co. v. Korn, 121 Or. 685, 256 Pac. 1047.

This answer to the merits, raised the issue of usury as a defense. This is an issue that was not part of the trustee's cause of action as stated in his complaint.

"The defense of usury must be distinguished from the right of action to recover a penalty for usury. Although the defense of usury is personal to a debtor, the right to assert this defense passes to the trustee." *Remington on Bankruptcy*, 5th Ed., Vol. 4, Sec. 1426, p. 136.

Since this defense exists, it was only proper to assert it in the reply to the merits to the alleged counterclaim as well as the objections to appellant's claim.

The referee held that the validity of the Heider mortgage was only indirectly involved in the suit in the state court (Referee's Certificate R. 42). This is true, because had the same transactions occurred, as alleged

in that complaint, without existence of the claimed security asserted by the appellant, or any claimed balance due appellant the trustee's rights to recover the moneys would have been the same.

It probably is proper to say that some of the facts involved in the state court litigation are the same as the facts involved in the appellant's claim filed in the bankruptcy court and objections thereto but the legal issues are different.

Answer to Contention That Trustee Is Bound by the State Court Proceedings

The trustee admits that as to the cause of action set out in his complaint, in the state court proceedings, he will be bound by the result thereof in the state court.

As to the appellant's authorities, *Herman v. Cullerton*, 13 F.2d 754 (App. Br. 9-10), was distinguished *supra*.

In re American Fidelity Corp., 28 F. Supp. 462 (App. Br. 10), involved a litigation commenced prior to bankruptcy over a fund and the court pointed out that it was questionable whether the bankruptcy court had either actual or constructive possession thereof. The trustee, with the bankruptcy court's permission intervened, and the judgment of the state court was binding upon him. The court recognized that there was certain functions of the bankruptcy court which are non-delegable (p. 468):

"Nor does it question that there are certain administrative functions which by their very nature are not capable of delegation."

In *Van Zandt v. Parson*, 81 Or. 453, 456, 159 Pac.

1153 (App. Br. 10), the same general rule is applied. When a trustee sues in a state court, he is bound by the adjudication; the question of the right of the bankruptcy court to pass on claims filed with it or determine liens upon funds in its possession were not involved.

In *Grant v. Buckner*, 172 U.S. 232, 238 (App. Br. 10), the court pointed out:

“The question presented is not how the estate belonging to the receiver shall be administered, but what is the estate belonging to him.”

Applying this test to the present case, the complaint filed by the trustee in the state court involves “what is the estate” belonging to the trustee, while the counterclaim attempted to be asserted attempts to deprive the bankruptcy court of jurisdiction to determine “how the estate . . . shall be administered.”

Winchester v. Heiskell, 119 U.S. 450, and *Fischer v. Pauline Oil Co.*, 309 U.S. 294, 303 (App. Br. 10), both apply the rule of the previous cases cited; as stated in *Brown v. Gerdes*, 321 U.S. 178, at pp. 185, 186:

“A bankruptcy trustee who by choice or by necessity resorts to a state court for the prosecution of a claim is of course bound by the adjudication made in the state proceeding. *Winchester v. Heiskell*, 119 US 450; *Fischer v. Pauline Oil & Gas Co.*, 309 US 294, 303. The state court has full control over the litigation. *But even as an incident thereto, it may not take action which involves the performance of functions which Congress has entrusted to the bankruptcy court.* See *Eau Claire National Bank v. Jackman*, 204 U.S. 522, 537-538.”

and in the quoted case, *Eau Claire National Bank v. Jackman*, *supra*, the court said:

“The bank also contends, in effect, that in such suit (to recover a preference) the validity of all other claims against the bankrupt can be litigated and whether they have received voidable preferences and have not been required to surrender them. The broad effect of the contention repels it as unsound. To yield to it would transfer the administration of a bankrupt’s estate from the United States District Court to the state court.”

**Answer to the Contention That the Principle
Is Still Applicable Where the State Court
Has Not Yet Rendered Judgment**

This contention is not correct. The cases cited do not support it.

In re Graceland, 73 F. Supp. 158, 161 (App. Br. 10), was a case where the trustee was expressly directed to try the title to property in the state courts and he instituted action for that purpose. Another action was commenced for the same purpose by others and the trustee intervened as a party defendant. The question was whether prosecution of the second action should be enjoined. The court said:

“Since the trustee was directed to try title in the state court, he cannot object that this result may be attained by means of the . . . cross complaint . . . rather than in his own action . . .”

These being the facts, this case is of no help in the matter before this court.

Scott v. Kelly, 22 Wall. (89 U.S.) 57, 59 (App. Br. 11), did not involve a pending action, but is another example of the proposition running through all the authorities cited by the appellant—that when a trustee in bank-

ruptcy secures authority to and does submit to the jurisdiction of a state court for the adjudication of a specific issue, that adjudication is binding upon the trustee and the matter cannot be re-litigated in the bankruptcy court.

Until there has been an adjudication, leave to sue can be withdrawn.

In *Investment Registry Ltd. v. C & M Elec. Ry. Co.* (CCA Wisc.), 251 Fed. 510, an Order had been entered authorizing suit against a receiver in the state court. Thereafter a motion to vacate that Order was filed. The court said, at page 512:

"If at any stage of the proceedings the court deems it proper and advisable that any demand or question be litigated elsewhere than in the federal court, it can authorize such litigation to be elsewhere instituted. But neither on principle nor authority does it follow that the court granting the leave to sue may not recall it, if before adjudication in such other tribunal the court granting the leave shall consider, either because of facts subsequently arising, or of new light coming to it as to then existing conditions, it would best subserve the due administration of the estate to recall the granted leave,"

and at page 513:

"If it appeared that any issue in the litigation had been determined by the state court in which the action was brought, pursuant to the leave granted, a different question might be presented."

And in *In re Locust Building Co.*, 272 Fed. 988, aff'd 276 Fed. 1023 (CCANY), a third mortgagee had obtained from the bankruptcy court leave to foreclose his mortgage in the state courts; the trustee had been directed by Order to sell the property covered by the

mortgage and to pay the mortgages (so far as held valid) out of the proceeds.

Thereafter, upon motion, the court stayed the foreclosure proceedings. The court said (272 Fed. at 989):

“If the state court did not deem it advisable or was unable to proceed with the liquidation of this claim and the determination of its validity within a reasonable time, the trustee could nevertheless in due course proceed before the referee or this court to determine how the fund should be distributed. . . .”

It is the trustee's position that the bankruptcy court reserved to itself the right to determine the validity of appellant's lien but if any consent to assert this lien in the state court be implied from the granting of the authority to bring the state court action, such consent was revoked or cancelled by the denial of the motion to dismiss on jurisdictional grounds.

The Bankruptcy Court Has Exclusive Jurisdiction to Pass on Claims Filed With It

The question for decision in this case is—does a trustee by going into the state court for the recovery of assets belonging to the bankrupt estate, thereby subject the assets of that estate to the jurisdiction of the state court so that the state court can pass on claims, determine the validity of liens upon funds in the custody of the bankruptcy court and thereby oust the jurisdiction of the bankruptcy court from the administration of the estate and the assets in its possession. The answer is clearly no—the state court's jurisdiction is limited to the controversy submitted to it and it cannot infringe

upon the other functions of the administration of the estate which are within the exclusive jurisdiction of the bankruptcy court.

The bankruptcy court has exclusive and non-delegable jurisdiction to pass on claims filed with it.

The United States Supreme Court in *Pepper v. Litton*, 308 U.S. 295, 304, said:

"Among the granted powers are the allowance and disallowance of claims; the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto; the rejection in whole or in part 'according to the equities of the case' of claims previously allowed; and the entering of such judgments 'as may be necessary for the enforcement of the provisions' of the act. In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts. *United States Fidelity & Guaranty Co. v. Bray*, 225 U.S. 205, 217."

In the cited case of *United States Fidelity & Guaranty Co. v. Bray*, supra, the United States Supreme Court, after citing Sections 2, 23(a) and 57(k), states the following:

"We think it is a necessary conclusion from these and other provisions of the Act that the jurisdiction of the bankruptcy courts in all 'proceedings in bankruptcy' is intended to be exclusive of all other courts, and that such proceedings include, among others, all matters of administration, such as the allowance, rejection and reconsideration of claims, the reduction of the estates to money and its distribution, the determination of the preferences and priorities to be accorded to claims presented for allowance and payment in regular course, and the supervision and control of the trustees and others who are employed to assist them."

The court in the last cited case further stated the following (p. 218):

“Of the fact that the suit was begun in the Circuit Court with the express leave of the court of bankruptcy it suffices to say that the latter was not at liberty to surrender its exclusive control over matters of administration or to confide them to another tribunal.”

Remington on Bankruptcy, 5th Ed., Vol. 5, Sec. 2369, p. 569:

“In general, neither a State Court, nor the United States District Court, has jurisdiction, even by express permission of the bankruptcy court, to maintain an action the object of which is to determine the validity or extent of a claim against a bankrupt estate that is in process of administration in the Bankruptcy Court, or to determine priorities in the distribution of the assets of a bankrupt estate in such custody; for the jurisdiction of the Bankruptcy Court over the administration of the bankrupt estate is original and exclusive; and the Bankruptcy Court has no authority to delegate that jurisdiction to another court.”

To the same effect, see Collier on Bankruptcy, 14th Ed., Vol. 3, Par. 57.14, p. 185.

**The Property Being in the Custody of the
Bankruptcy Court, Its Jurisdiction to
Determine the Validity of Liens
on the Property Is Exclusive**

In *Isaacs v. Hobbs Tie & Timber Co.*, 282 U.S. 734, the court said at pp. 737-738:

“Upon adjudication, title to the bankrupt’s property vests in the trustee with actual or constructive possession, and is placed in the custody of the bank-

ruptcy court. *Mueller v. Nugent*, 184 US 1, 14. The title and right to possession of all property owned and possessed by the bankrupt vests in the trustee as of the date of the filing of the petition in bankruptcy, no matter whether situated within or without the district in which the court sits (citing cases). It follows that the bankruptcy court has exclusive jurisdiction to deal with the property of the bankrupt estate. . . . When this jurisdiction has attached the court's possession cannot be affected by actions brought in other courts. *White v. Schloerb*, 178 US 542; *Murphy v. Hofman Co.*, 211 US 562; *Dayton v. Stanard*, 241 US 588. This is but an application of the well recognized rule that when a court of competent jurisdiction takes possession of property through its officers, this withdraws the property from the jurisdiction of all other courts which, though of concurrent jurisdiction, may not disturb that possession; and that the court originally acquiring jurisdiction is competent to hear and determine all questions respecting title, possession and control of the property. *Murphy v. Hofman Co.*, supra; *Wabash R. Co. v. Adelbert College*, 208 US 38; *Harkin v. Brundage*, 276 US 36. Thus, while valid liens existing at the time of the commencement of a bankruptcy proceeding are preserved, it is solely within the power of a court of bankruptcy to ascertain their validity and amount and to decree the method of their liquidation. *Ex parte City Bank of New Orleans*, 3 How 292; *Houston v. City Bank of New Orleans*, 6 How 486; *Ray v. Norseworthy*, 23 Wall 128; *In re Wilka*, supra; *Nisbet v. Federal Title & T. Co.*, 229 Fed 644. The exercise of this function necessarily forbids interference with it by foreclosure proceedings in other courts, which save for the bankruptcy proceeding would be competent to that end. . . ."

(P. 739):

" . . . The jurisdiction in bankruptcy is made exclusive in the interest of the administration of the

estate and the preservation of the rights of both secured and unsecured creditors. This fact places it beyond the power of the court's officers to oust it by surrender of the property which has come into its possession. *Whitney v. Wenman*, 198 US 539; *In re Schermerhorn*, 145 Fed. 341. Indeed a court of bankruptcy itself is powerless to surrender its control of the administration of the estate. *U. S. Fidelity & G. Co. v. Bray*, 225 US 205. The action of the trustee in removing the cause, could not, therefore, divest the Texas District Court of its jurisdiction. . . ."

See also *Irving Trust Co. v. Fleming* (CCA 4th Cir.), 73 F.2d 423 at 427.

Having Filed His Claim Appellant Is Subject to Jurisdiction of Bankruptcy Court

In *Gardner, Trustee, v. New Jersey*, 329 U.S. 565, the court said:

"It is traditional bankruptcy law that he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide the consequences of that procedure. *Wiswall v. Campbell*, 93 US 347, 351."

See also *In re McCallum* (DC ED Pa.), 113 Fed. 393.

CONCLUSION

It is respectfully submitted that the lower court must be affirmed.

Respectfully submitted,

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